



# A PRELIMINARY AGREEMENT IN FRANCHISING BUSINESS – RISKS AND CHALLENGES

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## ABSTRACT

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This article constitutes a Preliminary Agreement in Franchising. The research process focuses on theoretical and practical aspects of legal issues that concern franchise agreement.

This article represents problematic legal issues, experience and tradition in legalizing pre-sale information disclosure plays a significant role in the franchise business. Franchisee maintenance justice mechanisms signify the importance of pre-sale information disclosure and provision principles in the initial stage of making pre-agreements.

The article deals with certain controversies revealed in a franchise business caused by the absence of legal regulations at the pre-contractual stage. It emphasizes the lack of a mechanism to protect franchisees' rights – information disclosed in the Franchise Disclosure Document. It contains recommendations on how to solve existing problems.

As a result of observing different models of legal systems and regulations in the pre-contractual stage, it becomes necessary to integrate this new franchising system and pre-sale information disclosure into Georgian law.

On the one hand, this study suggests implementing legislation and franchising regulations by combating several legal problems.

On the other hand, the research accentuates the adopted model law on information disclosure, “UNIDRUA”, that will be a strongly recommended model contract for such a country as Georgia since it lacks a special law on franchising. The analysis based on this research can be applied by commercial organizations and entrepreneurs that run businesses in terms of franchising.

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## INTRODUCTION AND RESEARCH OBJECTIVE

### 1. THE MEANING OF PRE-CONTRACTUAL STAGE IN FRANCHISE BUSINESS

#### 1.1 Foreign doctrine about pre-contractual stage

Pre-contractual stage: This is an Essential period that involves contract preparation procedures. Despite long-term contract negotiations, the parties are most likely to sign the contract at a very early stage. It is the legal basis for administrative compulsion, including several principles that must be considered when making a franchise agreement.<sup>1</sup>

A franchise relationship is a kind of relationship between the franchisor and the franchisee and involves regulations and standards to define and protect the quality of the service or products to be provided. The franchisee's business is one which they are licensed to carry out in accordance with the terms of their contract with the franchisor.<sup>2</sup> The franchise agreement is the basis of the relationship between the franchisor and the franchisee in all franchises. The relationship between franchisors and franchisees has often been termed a “commercial marriage”. In many ways, this is true, though the difference is that in the franchise relationship, there must, by definition, be a “senior

partner” – the franchisor. Also, the franchise agreement defines the entire basis of the relationship upfront so that both parties know their rights and obligations to the relationship<sup>3</sup>.

A franchise agreement: This is an agreement between a franchisor (exclusive rights-holder) and a franchisee that sets out certain rights and obligations for franchisees to purchase a franchise within restricted franchise territory in accordance with those terms and submission period dates that are defined in the contract.

The complex of exclusive rights (licensed complex) – Intellectual property rights of all objects (trade mark, trade name, service marks, patents, covered (obscure) information, production secrets (know-how); Goodwill.<sup>4</sup>

Doctrinal studies assess pre-contractual agreement as a traditional version aroused due to agreement responsibilities. We all know the very postulate: The general rule is that signing the agreement's appropriate form isn't preceded by establishing mutual intercourse between the parties. What's more, preparation for pre-contractual agreement gives resistance to the dichotomy (reciprocity) approach of civil legal liability that is attributed to Roman law.<sup>5</sup>

If we analyze foreign Doctrinal research, we may come to the following conclusion that the Continental-European, as well as the Anglo-American legal system, tends to impose several restrictions and duties on both parties to protect The obligation of

1 Vashakidze, G., Gelashvili, I., Baghishvili, E., Rusiashvili, G., Aladashvili, A., Meskhishvili, K., Motsonelidze, N., Batlidze, G., Zorbenadze, S., Gatserelia, A., Svanadze, G., Robakidze, I. (2019). Commentary to the Civil Code of Georgia. Book III, Tbilisi, GIZ, p. 99.

2 Greene, N., Newton, D., Olson, K. J. (2021). The Annotated Franchise Agreement <https://www.franchise.org/faqs/basics/what-is-a-franchise> (Last access: 07.06.2024).

3 Hussein, M. A. Z. (2019) Legal Aspects for the Pre-contract Stage, Publisher: دبى مسح رهاظل، p., 40;

4 Association of Franchising Projects. (2000). Small and medium business in Franchising, (Bulletin). ISBN 99928-945-98. Publishing “Thani”.

5 Zweigert, K., Kötz, H. (1998). An Introduction to Comparative Law. Oxford, Vol. II, Oxford University Press, p. 291-300.

faithful business and in case of violation of requirements and misconduct the side that has inflicted some kind of wrong upon another party or has brought some kind of harm to his personal property is to make reimbursement for the loss of income.<sup>6</sup>

Pre-contractual liability of franchising is likely to be a special element when providing pre-sale disclosures.

It is very interesting if we realize the meaning of the pre-contractual stage in the franchise business. What is the core (essence) of business formation? One side that is right holder is maybe a professional entrepreneur (commercial organization), A contrario franchisee (beneficiary) who isn't unlikely to possess the necessary business experience and some kind of professional level, which compels him to compensate for this disability by making a franchising agreement. Each side aims at making a maximum profit because of the actual inequality of those two entering a franchise business; the one who is always strong and more omnipotent and experienced is a franchisor, and the weaker side is mostly a franchisee rather than a right-holder. That's why regulating franchise businesses necessitates solving the problem of creating legal guarantees to protect a franchisee.

Actual inequality of the parties entering a franchise business might occur in the early pre-contractual stage. In fact, in this stage, two negative factors are juxtaposed. First, as it has already been mentioned, this is insufficient job experience for a franchisee (beneficiary), and this is a plus for the franchisor as he/she possesses a preferable position. Second, the authoritative factor in this respect is that there is no clearly modified legal regulation in the pre-contractual stage.<sup>7</sup> So fighting the legislative vacuum is likely to be critical in the early pre-contract stage that's why it is significant to form special regulation to avoid insolence and violation of franchisee's rights and the diversion from the equality principles of civil legal relations.

For instance, if we analyze the hypothetic model for a franchise business, according to civil law, a franchisee (beneficiary) is to make up his mind whether to trust and accept insufficient and ob-

scure information about a franchisor's job performance (know-how) his entrepreneurial activities and take notice of those data that a franchisor deems necessary, desirable or scratch the surface and get things intuitively what is the business perspective before signing a contract.<sup>8</sup> Can a franchisee make a motivated and argumentative decision over franchise agreement in such a legal vacuum? Is it legal to allow a franchisor decide the extent of information disclosure and provision in the early pre-contractual stage?

The negative answer is irrevocable, which can be explained in the following way: It's foremost to work out an efficient and effective legal mechanism in the early pre-contractual stage to provide equal conditions for the parties entering a franchise business.

Common law system, as well as continental, signals what is the key instrument of the legal mechanism to protect the interests of a franchisee (beneficiary), and this major principle is the provision of pre-sale disclosure that is activated in the initial stage of business formation.<sup>9</sup>

If we define schematic processing, this principle lies in the fact that a franchisor (right-holder) is under obligation to give and represent essential information to a potential franchisee (beneficiary) before the contract is drawn up.

Before we get to the conclusion and put forward the answer to the question of whether our legal system needs a new legal institution, pre-sale information disclosure and transferring in the early pre-contractual stage, it's very important to be aware of its legal nature, because such research will help us understand how our legal system organically absorbs this foreign construction.

## 1.2. Problems at the pre-contractual stage and a special law on information disclosure

A franchise business's pre-contractual stage is usually regulated by a special information disclosure law, which imperatively addresses a fran-

6 Ali, A. O. (2020). Legal Aspects of the Franchise Contract, an Analytical Study. Arab Renaissance House Publishing, p. 231.

7 Kokiashvili, M. (2009). Franchising and its legal regulation. Tbilisi, Publishing "Meridiani", p. 20.

8 Emrich, N., Twiehoff, M. (2022). Die 7 Irrtümer im Franchise: Was Einsteiger wissen müssen. Hamburg, S. 20.

9 Kucher, A. N. (2005). Theory and practice of the pre-contractual stage: a legal aspect. M. Statute, p. 213.

chisor's obligation, i.e., requirements to provide a franchisee with equivalent objective information earlier than signing a contract. This kind of obligation seems natural; a potential franchisee (This is a legal action in accordance with its legal nature) remains connected to another part using a set of rights and obligations before forming contractual relationships, and this makes us familiarize ourselves with the special pre-agreement statement within the framework of legal relations which involves unilateral commitment, a franchisee's right to be provided with information and requirement to make a franchisor meet all the liabilities concerning pre-sale franchise disclosure.

Thus, the distinctive features of the franchising contractual mechanism are a continual legal relationship, the franchisor's right of control over the franchisee's activities, and the franchisee's commitment to follow the advice and directives of the franchisor. In case of not yielding to the range of requirements interconnected and mutually related contractual partners are to abide by any liability mechanism. (Legal systems in the case of several foreign countries involve intersectoral liability mechanisms that consist of private and public legal norms (France, Italy).

What's the aim of franchising legal relationships? It imposes obligations upon franchisees as well as franchisors and affects pre-contractual conduct as well as the fundamental elements of the relationship. Pre-contractual relations and contract negotiations are made separately and provided the franchise agreement is drafted or terminated, it won't have any bias upon these pre-contractual relations, i.e. it recognizes the need to activate liability mechanism imperatively in case of violation of rights and interrupting a franchisee from being provided by the pre-contractual duty of Information disclosure even though franchise contract is never signed.<sup>10</sup> Existence of pre-contractual legal relationships is defined by two factors: submission period of potential franchisor's information liability terms and potential franchisee's rights terms to have confidentially protected, detailed franchise information and resources and these terms are negotiated and endorsed mutually, and when the contract is overdue, or all the commitments are

fulfilled, then it results in cancellation of pre-contractual negotiations.

## 2. CULPA-IN-CONTRAHENDO DOCTRINE

It is very important to make first Pre-contractual liability of legal regulation reform (for example, in Germany, while focusing on obligations law reform, it recognized the need to expand the German Civil Code with a special norm & 311 (2) in 2002, that imposes both franchise business partners to act honestly when franchise negotiations are underway and second, we shouldn't resist to the presumption that pre-sale information disclosure process follows doctrine of (culpa-in-contrahendo) pre-contractual relationship between the parties entering a franchise business. The main intention is to enable the principle of good faith in a contractual relationship of franchising.

It is necessary to analyze the franchisor's (right holder) information obligation in detail. The legal obligation involves the representation of a franchise disclosure statement similar to the offer to a great extent. What's the meaning of offer and its principles? Let's compare it with the information disclosure statement:

The legal nature of the Offer lies in the fact that it shows the willingness of the partner to draft an agreement that conveys the intentions of the person who has already made a suggestion. Due to the proposal, he asserts that the agreement is made for the addressee, who accepted it. The Offer concerns the distinctive terms, conditions and issues of the agreement.<sup>11</sup> It can be concluded that the Offer is quite clarified and modified to express the Offerant's wish. In case of acceptance, sign the following document. If we get to the bottom of the franchise disclosure statement and analyze its essence, we will realize that the Offer, as well as the franchise disclosure statement, share the same characteristic feature: "comprehensibility (clearance)". Moreover, a special law on franchising urges a franchisor to provide a franchisee with

10 Martius, W. (2024). Fairplay Franchising, Springer Gaber. 4. Auf., S. 55.

11 Vashakidze, G., Gelashvili, I., Baghishvili, E., Rusiashvili, G., Aladashvili, A., Meskhishvili, K., Motsonelidze, N., Batlidze, G., Zorbenadze, S., Gatserelia, A., Svanadze, G., Robakidze, I. (2019) Commentary to the Civil Code of Georgia. Book III, Tbilisi, GIZ, p. 99.

an information disclosure statement alongside all the detailed and exhausted sources of information involving substantial terms and conditions.

There is no doubt that when a potential franchisor provides a franchisee with an information disclosure statement, by doing this, he expresses his willingness to form a franchise relationship and sign a franchise contract; what's more, any pre-contractual legal regulation model for franchise business contains franchise disclosure statement, and its content consists of the very text of the agreement and Offer doctrinal definition is similar to commentary made in Criminal Code – the article 329. "Offer is a proposal to Offer an Agreement, show one-sided willingness and meet expectations of accepting this agreement from the other side, and postulates legal regulation results for both sides standing for a franchise business, i.e. involving Offerer and addressee "(Acceptant)".<sup>12</sup> Offer has a broad meaning, and its identifying features are doctrinally interpreted: The First feature is clearance of Offer, and due to it, the addressee should clearly define the Offerer's willingness. Second – Offer directives that assert acceptance of suggestions, terms and conditions from the addressee for successful business plan implementation. Third, it's the content of the Offer – it must contain substantial terms and conditions of the contract. The fourth element is addressee – It should be obvious to whom the offer is addressed.

## 2.1. Disclosing pre-sale information – a distinctive principle

Considering prominent elements and factors while concentrating on information disclosure, we may conclude that the Offer is mostly characterized by clearance, directiveness and content. As for the addressee, the Information disclosure document is always directed toward the potential franchisee.

Therefore, the information disclosure document is characterized by every trait of "Classic Offer's" shares; therefore, its content is regulated in every pre-contractual legal regulation model by the special law on franchising. (The imperative norms determine the content of Offer That's why it

enables us to conclude that the information disclosure document has the same nature as Offer but is "special Offer with imperative steps".

Thus, disclosing pre-sale information on the pre-contractual stage of franchising is the distinctive principle. It is associated with the classical contract-signing concept involving minor analysis toward the offer content. This enables us to give a positive answer to the question that there is no need to copy construction law research methods; moreover, in this particular case, drastic reforms in existing legislation are unnecessary.

## 2.2 Pre-contractual liability in European legal family

The pre-contractual liability institute was originally founded in the German legal system and then interpreted by the meaning of French jurisdictional terms. Nowadays, it is depicted and enacted in many normative acts of those countries that attribute to continental European legal family (Videlicet in Italy, France, Spain, and Switzerland).<sup>13</sup> Notwithstanding the differences in the contents of the pre-contractual liability mechanism, in the case of different national legal systems, it is notable that the main principle of pre-contractual liability remains a civil-legal liability, implying opportunities to violate and terminate contract terms and remunerate the damages caused by unlawful acts.

Alongside it, existing pre-contractual liability in concrete separate national systems isn't limited to civil legal liability only, but also it foresees for minor violations administrative liability and for serious violations – criminal liability (for example, in France, Italy, and Spain). Regulating pre-contractual stage in franchising is guaranteed neither by the Civil Code nor any legislative act in Georgia. So, it should be considered that the Georgian model for legal regulations should be established at the pre-contractual stage with the main objective of enacting and legalizing intersectional liability

<sup>13</sup> Nedzel, N. E. (1997). A Comparative Study of Good Faith, Fair Dealing, and Precontractual Liability, 12 TUL. <EUR. & CIV. L.F. 97.p.147; Southern University Law Center; [https://elsevier-srrn-document-store-prod.s3.amazonaws.com/15/11/02/ssrn\\_id2685374\\_code624997.pdf?response-content-disposition=inline&X-Amz-Security-Token=IQoJb](https://elsevier-srrn-document-store-prod.s3.amazonaws.com/15/11/02/ssrn_id2685374_code624997.pdf?response-content-disposition=inline&X-Amz-Security-Token=IQoJb)

mechanisms to avoid unlawful acts. That kind of regulation model would involve public and private legal forms.

When we talk about the pre-contractual stage and preparation of the franchise disclosure document, we shouldn't forget the existence of the model franchise disclosure law officially adopted by the UNIDROIT Study Group on franchising on 25 September 2002. According to the franchise agreement, preparing a model franchise disclosure law started in 1985 when the Governing Council of UNIDROIT worked on the UNIDROIT Conventions<sup>14</sup> on International Leasing and International Factoring.

The first and foremost factor in model law is regulating franchise relationships by providing pre-sale information disclosure in the pre-contractual stage. Model law, of course, is short and consists of a single preamble and ten chapters. As for the preamble, it depicts and forwards the significant role franchising plays in many high-ranked countries, for example, but the chapters concern information disclosure and provision elements that must be taken into account before drawing up an agreement.

Information vacuum challenges compass unavailability and disclosure of information concerning the parent company and beneficiary's company. (i.e. information on both parties entering the franchise business). This specific feature in business formation is characterized as transparency and disclosure that restricts franchise efficiency and effectiveness. This means that some of the elements of a system cannot be seen but can nevertheless affect the system's operation. Many challenges in franchise systems can be avoided if franchisors and franchisees have more open and frequent communication, mutual respect and transparency. That is why information disclosure concerning franchise business entities seems to be of most requireable principles at the pre-contractual stage according to franchising legislation in certain countries such as The USA, France, Germany, Australia, Belgium, Brazil, Indonesia, Spain, Canada, etc. Violating certain aspects of franchise agreement obligations is sanctioned even by

criminal liability. Unfortunately, no chapter in the Civil Code will regulate franchise business in the pre-contractual stage.

To overcome a series of challenges, the franchise industry necessitates law enforcement and representation of ("Law on Franchising", law on "Changes and Amendments to the seventh chapter in Civil Code"), parties entering franchise business are bound to abide by the law to disclose any special information at the pre-contractual stage. Developed countries, through special disclosure obligations put onto a franchisor, ease franchisee destiny by formulating its inner will to conclude a franchise agreement. Having received disclosure information, the franchisee fully understands the meaning of its actions directed to franchise agreement execution. Thus, in such a situation, we may conclude that the foreign franchisee's expression of will corresponds to its inner will.

If information disclosure obligations are terminated or violated, then we may face several challenges even in developed countries: e.g. The existence of a large number of franchisors who lack successful technologies, The existence of those franchise companies that work only on gathering royalties and give nothing in exchange for this payment (Franchise royalty is a sum paid to the franchisor. It typically is the percentage of sales (usually the gross) that the franchisees pay to the franchisors). The existence of subsidiary companies, i.e., franchisee companies, seeks the way and resort to certain measures to face business challenges by drafting a franchise contract. The agreement gives both parties a clear understanding of the basis on which they will continue to operate.

## RESULTS AND CONCLUSION

There is no doubt that when a potential franchisor provides a franchisee with an information disclosure statement, he expresses his willingness to form a franchise relationship and sign a franchise contract. In addition, any pre-contractual legal regulation model for business consists of a franchise disclosure statement, and its content involves the agreement's text and the offer doctrinal definition, similar to commentary made in Civil Code Georgia.

14 UNIDROIT Principles of commercial contracts. (2016) <https://www.unidroit.org/instruments/commercial-contracts/unidroit-principles-2016/> (Last accessed: 07.06.2024).

Considering prominent elements and factors while concentrating on information disclosure, we may conclude that the offer is mostly characterized by ineligible clearance, directiveness and content. As for the addressee, the Information Disclosure document is always directed towards the potential franchisee.<sup>15</sup>

Therefore, every trait of “Classic Offer” shares characterises the information disclosure document. Therefore, its content is regulated in every pre-contractual legal regulation model by the spe-

cial law on Franchising (The content of the offer is determined by the imperative norms). As a result, this enables us to conclude that the Information Disclosure document has the same nature as the “Proper Offer”; however, this is a “special offer with imperative steps”.

In summary, disclosing the pre-sale information on the pre-contractual stage of franchising is the distinctive principle. It is associated with the classical concept of contract signing that involves a minor offer content analysis. Thus, its content often isn't visible. This allows us to give a positive answer to the need for reforms in the existing legislation.

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15 Schwenken, C., Riedl, H. (2024). Praxisleitfaden Franchising, Strategien und Werkzeuge für Franchisegeber und –nehmer, München, Springer Gaber, 3. Aufl., S. 20.

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